Defining Our Long-Term Fiscal Challenges

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> ***When the Athenians finally wanted not to give to society but for society to give to them, when the freedom they wished for most was freedom from responsibility, then Athens ceased to be free…*** **Edward Gibbon**

Thank you Mr. Chairman and members of the committee for the opportunity to testify on defining our long-term fiscal challenges. I'd like to begin by undertaking an imaginary exercise with you.

Suppose that during William Howard Taft's presidency, Congress had enacted laws that would predetermine all spending and tax subsidies throughout the 21st century. As economic growth led to higher government revenues, those legislators continued to prescribe—from six feet under—how to divvy the spoils. Their ingrained policy wheels would run over future elected officials and voters and prevent any new priorities unless past promises were rescinded.

Unable to see their way out of this logjam, our next generation of elected officials might try—albeit, unsuccessfully—to waddle back and forth between promising even more relative to what could be delivered and enacting only symbolic policies that accomplish little. Each political party would hope to see the other forced into damage control on the budget, but view it as political suicide to do anything substantial itself.

Ludicrous scenario? Not really. In recent decades, we have essentially wound just such a straightjacket policy around ourselves. The main culprits have been in the broad areas of retirement, health, and taxation—essentially those parts of the budget where members of Congress, many now dead or retired, succeeded in enacting permanent policies that not only skirted annual decision making, but, worse still, received ever-larger shares of national income and of government revenues. At the same time, of course, these policymakers indirectly required future generations to pay the tab or to raise the resources to meet those promises.

Eternal Commitments of Program Growth for An Unknown Future

Make no mistake about it. This particular type of fiscal crisis is unique in our nation's history. Never before has the law pre-ordained so much of our future spending patterns. Never before have dead and retired policymakers so dominated officials elected today. And never before has so much of policy bypassed the traditional set of breaks applied through normal democratic decision-making.

When the nation dramatically increased its financial obligations in the past—through wars, the costly Louisiana Purchase, in depressions—the budgetary commitments were temporary, no matter how large the price tag. The permanence of our newer obligations—for retirement security, health care, and many tax subsidies—is different and inappropriate. It makes no more sense to commit future economic resources than it would be to decide today where to station troops until the next millennium.

Perhaps the most costly part of current budgetary policy is its political repercussions. It takes democracy away from voters. It treats future generations like adolescents who cannot be trusted to do the right thing. It leads to weak leadership and stymies the creativity of elected officials. Left alone, it leaves the current Congress with almost no control over its own budget.

There is no way out of this labyrinth by merely constructing it further, simply building more walls through new programs and tax subsidies without attention to what has already been constructed. Only major systemic reform can restore a normal democratic process. Each generation must regain the right to decide spending and tax priorities based on the nation's current needs, not on past anticipation. We need budget slack—that is, wiggle room for new policy—between *future* government revenues and *current* spending commitments for the future.

The deficit is not an adequate focus for solving this fiscal mess, since the deficit is only a symptom. Even if Congress were brave enough to enact laws to project exactly zero deficits in the future, there would still be no future slack. After all, a reform looking only to deficits would not create any positive slack. If the economy quintupled in size, as it did last century, and revenues also quintupled (or quadrupled or sextupled, depending upon how political power evolved), we still would have laws in place that prescribed policy for decades and centuries to come. Again, I note, this lack of slack is unprecedented.

Seeing Opportunity

Fixing the budget is easy to achieve economically. Slack in budgets is the normal course for households, businesses, and—until very modern history—government. Households and businesses seldom sign contracts today for what they are going to buy decades in the future. Federal budget slack is being eaten away by promises on both spending and taxes that, taken as a whole, are now impossible to fulfill. Restoring democratic choice is almost entirely constrained by politics, not economics—although failure to deal with the politics can have severe economic consequences.

One way to see opportunity in this fiscal mess is simply to realize that turning the budget upside down means turning it right-side up. That is, we must recognize that the budget priorities (now set automatically, often by moldy legislation) are themselves upside down relative to our true societal problems. We are scheduled to spend ever-rising amounts as a response, not to problems, but to advances in well-being—in particular, gains in life spans and improvements in health care. Where we have problems as a society—children unattended by adults, rising numbers of families without health insurance, failures of our educational system, areas with too high crime rates, and homeland security—we now claim we can't do much because of growth in other commitments.

We should also recognize opportunity in people in their late 50s, 60s, and 70s, who have now become the largest underutilized pool of human resources in the economy. They represent for the first half of the 21st century what women did to the labor force for the last half of the 20th century. I believe that coming years will see substantial demand for this talent, and it is mainly our inherited institutions, public and private, that are blocking us from making full use of these valuable people.

In the remainder of my testimony, I would like to highlight ten extremely important consequences of our current budgetary situation—consequences that arise from pre-committing so much of our future revenues.

Consequence 1: A Budget Increasingly Oriented Against Growth

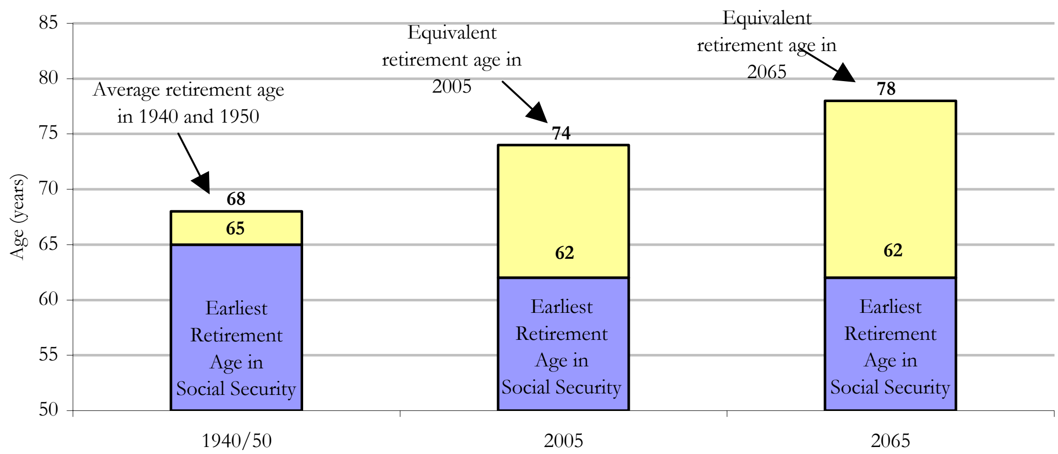
Larger shares of our budget spent on retirement benefits leaves an increasingly smaller share of the revenue pie available to finance activities more likely to promote productivity—nursing advice for pregnant mothers, early education for the very young, and additional training, mentors, and after-school activities for older children. Over time, the net result of a continually greater share of the budget for consumption likely will mean a smaller share for investment in human capital, which, in turn, likely leads to lower rates of overall economic growth and less economic gains for future generations.

Consequence 2: An Increasingly Middle-Aged Retirement System

Our system of elderly support has morphed into a middle-age retirement system. People already spend close to one-third of their adult lives in retirement. The average Social Security annuity for a man retiring at 62 in 2006 lasts 19 years; for a woman, 22 years, and for the longer living of a couple, at least 26 years. The numbers are even higher for those with above-average lifetime earnings.

When Social Security was young—for instance, in 1940 and 1950—the average worker retired at about age 68. To retire for an equivalent number of years on Social Security, a person would retire at age 74 today and age 78 in another 60 years (figure 1). Perhaps the most important budgetary decision we have made over the very long-term in Social Security has been to provide more and more years of retirement support.

Figure 1: Program Retirement Age--Indexed for Life Expectancy



Source: C. Eugene Steuerle and Adam Carasso, The Urban Institute, 2007. Based on data from the Social Security Administration, Birth Cohort Tables, 2007. Note: these figures are based on male life expectancies as reported by the 2006 Trustee's Report

Consequence 3: A Scheduled Drop in Labor Force and Economic Growth

Beginning in 2008, most economic projections include a slower growth rate of the labor force (see figure 2) and, consequently, of the gross national product—partly because so many people in late middle-age are scheduled to drop out of the labor force. Inadequate attention is being paid to these labor force issues and to their budgetary consequences.

Figure 2. Labor Force Projections

Annual Growth Rate			
1990-2000	2000-2010	2010-2020	2020-2030
1.33%	0.95%	0.63%	0.39%

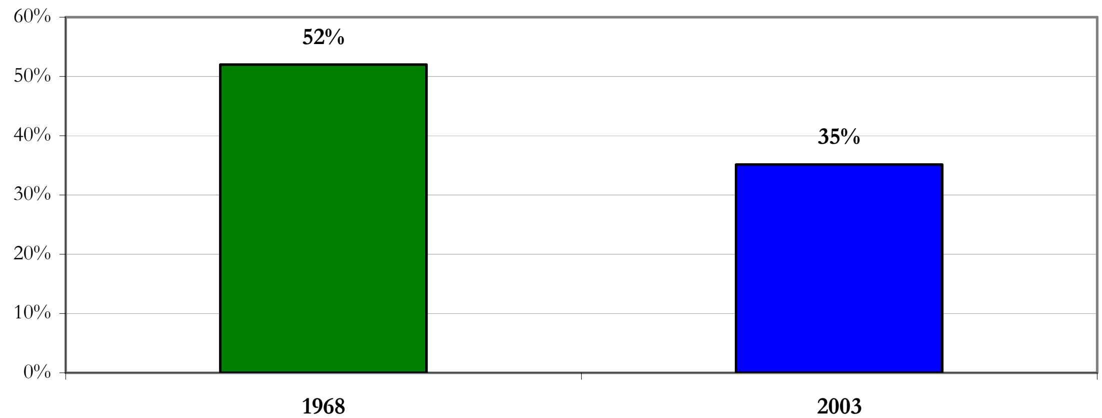
Source: C. Eugene Steuerle and Gillian Reynolds, The Urban Institute, 2007. Based on data from Mitra Toossi, Bureau of Labor Statistics, A New Look at Long-Term Labor Force Projections to 2050, Table 4.

Thus, when looking at old-age programs, the increase in beneficiary payouts is only half the story. A decline in revenue growth also occurs. For any given tax rate supporting old-age programs, a structure of significantly higher benefits can be maintained if people work longer, partly because there are more revenues available.

Consequence 4: Less Attention to the Truly Old and Most Vulnerable

Almost every year a smaller share of Social Security benefits goes to the oldest and most vulnerable in terms of health needs and incapacity for working (figure 3). If progressivity is defined by how well the vulnerable are served, the system is becoming less progressive every year. Social Security also discriminates against single heads of household, who are often more vulnerable than many spouses who work less, raise less children, pay less taxes, yet still receive higher benefits.

Figure 3: Proportion of Men's Social Security Benefits Going to Men With Less Than 10 Years Remaining Life Expectancy

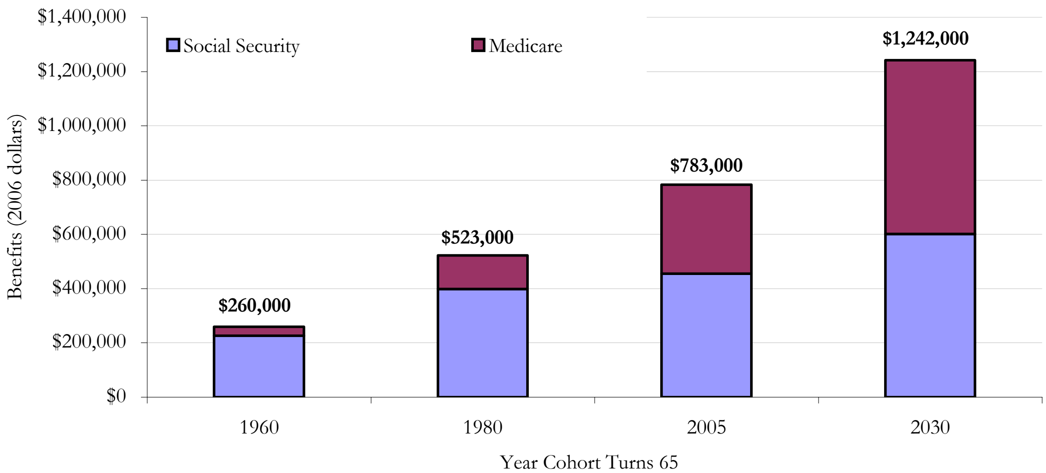


Source: C. Eugene Steuerle, Adam Carasso, and Gillian Reynolds, The Urban Institute, 2007.
Based on data from the Social Security Administration's 2005 Annual Statistical Supplement, Table 5A.1.1

Consequence 5: Program Millionaires

In today's dollars, lifetime benefits—Social Security and Medicare—for an average-income couple have risen from about $260,000 in 1960 to $783,000 today to over $1.2 million for those retiring in about 25 years (figure 4). We cannot keep adding benefits for this part of the population without shrinking services provided to other parts of the population.

Figure 4: Lifetime Social Security and Medicare Benefits*
-- Average-Wage, Two-Earner Couple ($37.8K each) --



Source: Adam Carasso and C. Eugene Steuerle, The Urban Institute, 2006.
* Expected rather than realized benefits. Notes: The "average" hypothetical wage profiles are taken from the Social Security Administration. Lifetime amounts, rounded to the nearest thousand, are discounted to present value at age 65 using a 2 percent real interest rate and adjusted for mortality after age 65. Projections are based on intermediate assumptions of the 2006 OASDI and HI/SMI Trustees Reports.

Consequence 6: A Broken Tax System

Building eternal growth into permanent programs affects taxes as well as spending. Here are two examples of how tax subsidies are made to grow in ways similar to many expenditure entitlements.

First, Roth IRAs and Roth 401(k) plans have been designed to give many taxpayers *negative* or zero tax rates on income from deposits. These taxpayers can reap very substantial, compounding, tax benefits for decades to come—throughout their lives and those of their children. The 5- and 10-year budget windows fail to show the consequence of this very long-term budget choice.

Second, the employee exclusion for employer-provided health benefits is scheduled to grow continually faster than the economy. The additional amounts spent on this exclusion—over and above some base amount—likely lead to an increase in the number of uninsured because they add to spending on health, which, in turn, add to the cost of insurance. The higher cost insurance drives out some employers from offering insurance and drives away some consumers from buying it.

Consequence 7: Less Ability to Address Poverty and Its Causes

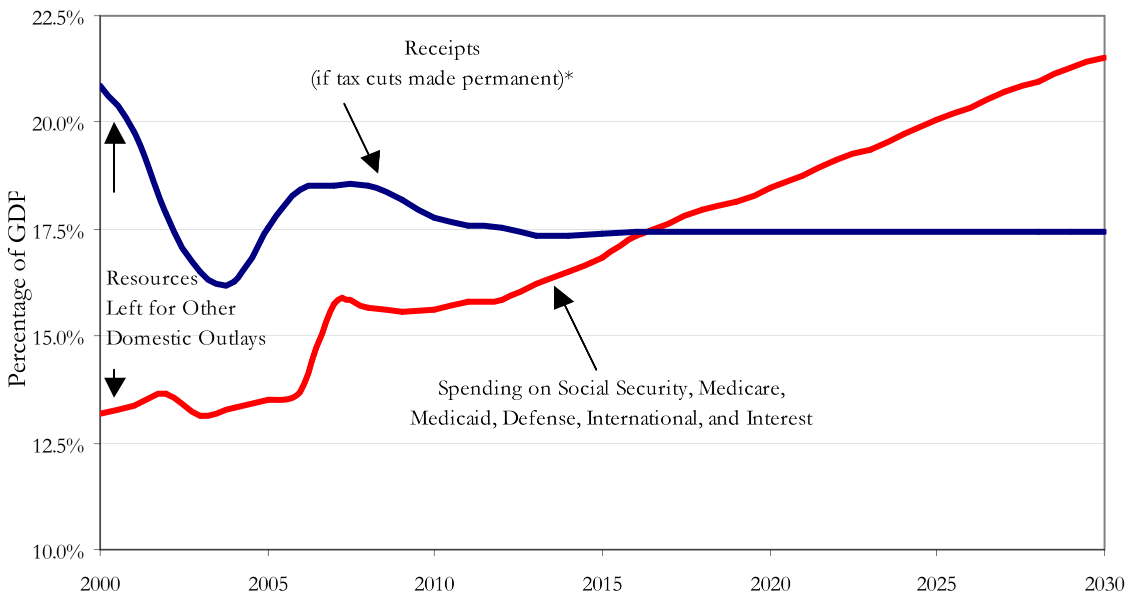
Within a quarter century, close to one-third of the adult population is scheduled to be on Social Security. Adding in other assistance programs, one-half of the adult population will depend on the government for significant amounts of their support. A government that treats everyone as needy treats no one as needy.

Within Social Security itself, most of the additional expenditures each year go toward raising benefits for everyone and financing early retirement, rather than reducing poverty among the elderly.

Consequence 8: A Squeeze on Children and Working Families

The squeeze on the budget is now, as baby boomers prepare to move out of the labor force. Assume merely that Social Security, Medicare, and Medicaid continue on automatic pilot, that interest on the debt is paid, and that, as a percent of GDP, existing levels of revenues are allowed to rise only moderately and defense expenditures are able to be reduced only moderately. Then in a very short period of time there is no revenues left for anything else (figure 5). Children and working families are especially likely to feel the pinch.

Figure 5: The Current Squeeze

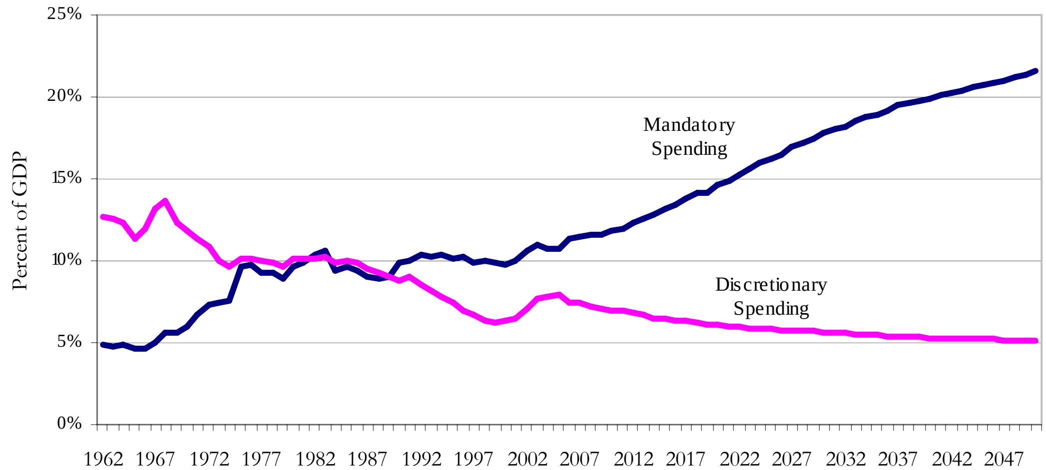


Source: C. Eugene Steuerle, Adam Carasso, and Gillian Reynolds, The Urban Institute, 2007. Authors' calculations based on data from CBO Budget Outlook (January 2007) and OASDI and HI-SMI Trustees Reports (2006).
*Assumes extension of 2001 and 2003 tax cuts and of expiring tax provisions and a permanent fix to the alternative minimum tax.
^ Assumes a moderate drop in defense and international spending as a percent of GDP.

Consequence 9: Less Ability to Meet the Needs of the Nation as They Arise

Every year Congress exercises less control over its own budget. We have taken from ourselves the freedom to allocate government resources by relying mainly on past decisions and formulas to determine how today's expenditures should grow. This is reflected in part by the declining share for discretionary spending , which has fallen from over two-thirds of the federal budget in the 1960s to about one-third today (figure 6).

Figure 6: Mandatory and Discretionary Spending as a Percent of GDP 1962-2050



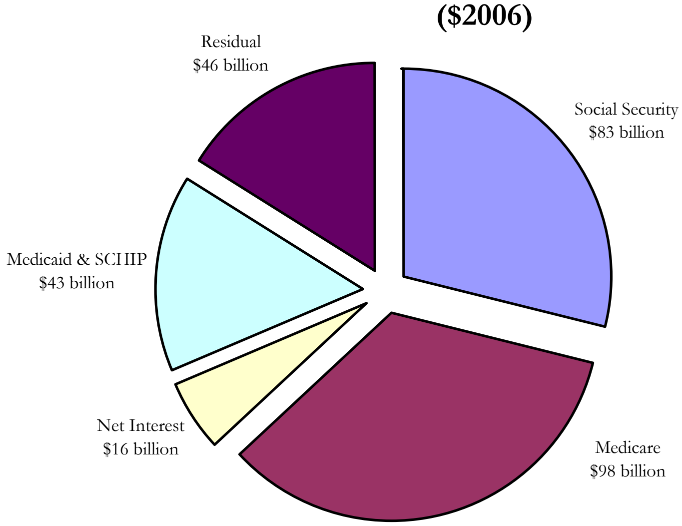
Source: C Eugene Steuerle and Gillian Reynolds, The Urban Institute, 2007. Based on data from the Federal Budget Historical Tables FY2007, various tables and CBO: The Long Term Budget Outlook, 2005.

I would like to make a recommendation here. I believe that there are better ways for budget authorities to clarify to the nation just how our priorities are being set in the budget. It requires no legislation. It only requires the Congressional Budget Office and the Office of Management and Budget to present budgetary changes *first* in a way that combines automatic and discretionary changes. An especially useful time to do this would be when the president offers his budget to the nation. Presenting changes only from "current law" to some proposed law, by way of contrast, is insufficient and often misleading. For instance, it suggests that reducing health cost growth from 8 to 7 percent is a "cut," while raising real spending on education or work subsidies from 0 to 1 percent is an "increase."

Figure 7 shows one way to combine automatic and discretionary changes relative to what I will call current practice. Here I show that according to the Congressional Budget Office revenues (in 2006$) are projected in 2010 to be $286 billion higher than in 2006, but that almost all of that increase is already committed to growth in Social Security, Medicare, Medicaid, and interest on the debt (the last of which is likely underestimated because of very strong assumptions about defense, tax increases, and what happens to national debt as many other programs are cut back under "current law.").[1]

[1] When the president's budget comes out, CBO and/or OMB would show, first, the total change from "current practice" (essentially current law in the previous year) to proposed law, then break out how much of that change was due merely from changes built into mandatory programs on both the expenditure and tax side of the budget from year to year and how much from additional proposed changes. These changes could also be shown as a percent of GDP, not merely in terms of changes in real taxes and spending. Other options are possible, but the main goal would be to present first all changes together.

Figure 7: How Future Increases in Revenue Have Already Been Spent 2010 versus 2006 ($2006)



$286 billion = increase in revenues in 2010 relative to 2006

Note: if Other Mandatory, Discretionary Non-Defense, and Defense outlays-- the major components of the residual -- maintain their same share of GDP by 2010 it will cost **$37, $59, and $62 billion** respectively, for a **total of $157 billion** to fund increases in these outlays.

Source: C. Eugene Steuerle and Gillian Reynoods, The Urban Institutue, 2007 . Based on data from CBO, Budget and Economic Outlook 2008-2017, various tables.

Consequence 10: A Government Dedicated to Baby Boomers-and No One Else.

The baby boomer generation—my generation—once talked about what type of government we could help create to best serve society. As now scheduled, our legacy is to bequeath a government whose almost sole purpose is to finance our own consumption in retirement. Not only haven't we come close to paying for the government we are scheduled to receive, but we plan to eat away at the rest of government that would serve our children and grandchildren.

CONCLUSION

By abandoning control over the budget to automatic, rather than discretionary, budget choices, we have put in place a system where politicians are forced to compete by giving away the future. Projected deficits are merely one symptom of this modern legislative push.

The budgetary consequences I've outlined follow from neither progressive nor conservative principles. They must be addressed on grounds of both fairness and efficiency if government is to serve all the people, if it is to be flexible enough to meet the needs of the times, if it is to be nimble in addressing new needs or emergencies, and if it is to restore democracy to the people.